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No. 529

In the Supreme Court of the United States

OCTOBER TERM, 1958

ALABAMA BY-PRODUCTS CORPORATION, PETITIONER

v.

GEORGE D. PATTERSON, DISTRICT DIRECTOR OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The findings of fact and conclusions of law of the District Court (R. 432–453) are officially reported at 151 F. Supp. 641. The opinion of the Court of Appeals (Pet. App. 1–16) is reported at 258 F. 2d 892.

JURISDICTION

The judgment of the Court of Appeals was entered on August 29, 1958. (Pet. App. 17.) The petition for a writ of certiorari was filed on November 20, 1958. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Whether the courts below erred in holding that the taxpayer had failed to discharge its burden of proving that there was no "representative market or field price * * * of a mineral product of like kind and grade" as compared with the coal mined by taxpayer in 1952, and hence that taxpayer was precluded from using the "proportionate profits" method of computing percentage depletion, under Section 39.23 (m)–1 (e) of Treasury Regulations 118, in determining the amount of the depletion deduction allowed by Section 23 (m) of the Internal Revenue Code of 1939.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of Sections 23 (m) and (n), 113 (a) and (b), and 114 (b) of the Internal Revenue Code of 1939 and Section 39.23 (m)–1 of Treasury Regulations 118 are printed in the Appendix, *infra*, pp. 12–18.

STATEMENT

The relevant facts, as adduced at the trial (R. 26–290), as stipulated (R. 315–345), as found by the District Court (R. 432–451) and as stated in the opinion of the Court of Appeals (Pet. App. 1–16), may be summarized as follows:

Alabama By-Products Corporation, the taxpayer, was engaged in the business of mining and selling coal, manufacturing coke, and selling coke and coal by-products during the taxable year 1952 and prior thereto. During 1952 the taxpayer mined coal from the Mary Lee and Black Creek seams of the Warrior coal field in Alabama. (Pet. App. 2.)

With respect to the Mary Lee seam, the taxpayer operated mines at Praco, Colta and Labuco. All of this coal was cleaned, broken, sized and loaded for shipment at a preparation plant located at the Praco mine. Coal from the Black Creek seam was extracted from mines located at Bradford and Thermal. This coal was also cleaned, broken, sized and loaded for shipment at preparation plants located at the mines. (Pet. App. 3.)

Most of the coal the taxpayer mined was utilized at its own coke ovens in the manufacture of coke to make grey iron foundry coke and malleable iron foundry coke. (Pet. App. 3.)

The evidence showed, and the courts below found, that there was an existing market for coking coal in the area of taxpayer's operations. The taxpayer itself purchased some coking coal from other mining companies, and there were extensive sales by other companies of coking coal mined from the other three bituminous coal fields in Alabama, as well as from the Warrior field. After the Mary Lee Coking coal was prepared at the Praco plant, the taxpayer sold 86,690 tons to purchasers at prices ranging from $5.05 to $7.93 per ton. A competitor, DeBardeleben Coal Corporation, purchased substantial amounts of this coal from taxpayer and others, and blended various qualities of coking coal in manufacturing coke to be sold on the same market as taxpayer's coke. The Republic Steel Corporation, the T. C. I. Division of United States Steel Corporation and the United States Pipe and Foundry Company also purchased Alabama coking coals during 1952. There were also

a number of sales agencies in Birmingham engaged in selling coking coal. (Pet. App. 3–4, 13.)

In 1952 the taxpayer reported a gross income of $6,233,080.10, and a net income of $4,555,457.81. A deduction of $20,729.50 for cost depletion of coal was claimed and allowed. In computing its depletion deduction, taxpayer first used a representative market price for coking coal, based on sales made, in order to arrive at the allowable percentage depletion. However, taxpayer elected to take cost in lieu of percentage depletion, since its mining operations were conducted at a loss in 1952 and percentage depletion is limited by the statute to 50 percent of the net income from mining. Thereafter, the taxpayer filed claims for refund of $590,353.16, based on revised computations of the allowable depletion deduction, on the theory that there was no representative market or field price for coal of like kind and grade during this period, within the meaning of the applicable Treasury Regulations, and that it was entitled to compute gross income from mining for purposes of percentage depletion by a proportionate profits method. (Pet. App. 4–5.)

The claims for refund were disallowed and the taxpayer sued for a refund. Both the District Court (R. 444) and the Court of Appeals (Pet. App. 13) held that there was a representative market or field price for coal of like kind and grade as that mined by the taxpayer, and that, therefore, the taxpayer was not entitled to compute percentage depletion by the proportionate profits method.

ARGUMENT

On the basis of all the evidence, the courts below found that the coal mined by taxpayer was "of like kind and grade" as other coal mined and sold in the Birmingham area, within the meaning of the applicable Treasury Regulations (Sec. 39.23 (m)-1 (e) of Regulations 118; Appendix, *infra*, pp. 16–17). There is no occasion to review this concurrent finding. The conclusion that taxpayer was required under the Regulations to use the "representative market or field price" method, rather than the "proportionate profits" method, of computing its depletion allowance is correct and involves no conflict of decision.

1. Section 23 (m) of the Internal Revenue Code of 1939, Appendix, *infra*, p. 12, permits, as a deduction in computing net income, a reasonable allowance for depletion of certain minerals. This allowance, in the case of coal, is based either upon the cost of the property (or the discovery value thereof) or is a percentage depletion equal to 10 per cent of the "gross income from the property," but not to exceed 50 per cent of the taxpayer's net income from the property. Sections 23 (m) and (n), 113 (a), 114 (b) (1), (2), and (4) (A) of the Internal Revenue Code of 1939, Appendix, *infra*, pp. 12–14.

"Gross income from the property" is defined by the statute as meaning the "gross income from mining"; "mining", in turn, is defined by the statute as including not merely the extraction of the mineral, but also the "ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or prod-

ucts." Ordinary treatment processes in the case of coal include "cleaning, breaking, sizing and loading for shipment." Section 114 (b) (4) (B) of the Internal Revenue Code of 1939.

Where, as in this case (Pet. App. 7; 13–14, fn. 12), the taxpayer's product is prepared for sale by processes beyond the ordinary treatment processes (here, the processing of coal into coke), Section 39.23 (m)–1 (e) (3) of Treasury Regulations 118, Appendix, *infra,* p. 17, specifically applies. In such case the "gross income" from the property for purposes of percentage depletion will be treated as the representative market or field price of a mineral product of "like kind and grade" after ordinary treatment processes have been applied. If there is no such representative market, the "gross income" for computing percentage depletion will be the representative market price of the first marketable product, less the costs and the proportionate profits attributable to the extraordinary treatment processes involved. The issue here narrows to whether the taxpayer has proved the absence of a representative market or field price for a mineral product of like kind and grade, so that it may compute its depletion deduction by the proportionate profits method.

The taxpayer makes no contention that the record fails to support the District Court's finding that there was a representative market price for coking coal in the Birmingham area. This finding, made by both courts below (R. 444; Pet. App. 13), is essentially factual in nature, and will not normally be reviewed anew. *Corn Products Co.* v. *Commissioner,* 350 U. S. 46, 51.

2. The courts below did not, as taxpayer contends, misconceive the meaning of the phrase "mineral product of like kind and grade" as used in Section 39.23 (m)–1 (e) of Treasury Regulations 118. The taxpayer argues that coking coals vary in their physical qualities and chemical characteristics, so that the type of coke produced by one may differ in many respects from that produced by another; and that, since other coking coals mined and sold in the area are not "interchangeable" with the coal mined by taxpayer, they are of a different "kind and grade." As the court below took pains to point out (Pet. App. 8–15), under this approach minor physical and chemical variations which may affect the nature and use of the ultimate product will determine whether a mineral is of "like kind and grade," and practically all coking coals would fall in different classes.[1]

The so-called "end use" test for classifying mineral products has been consistently rejected by the courts in other contexts. *Iowa Limestone Co.* v. *Commissioner*, 28 T. C. 881 (appeal pending, C. A. 8th); *Spencer Quarries, Inc.* v. *Commissioner*, 27 T. C. 392 (Acq. 1957–2 Cum. Bull. 6); *Virginian Limestone*

[1] In the words of the court below (Pet. App. 13):

"The District Court concluded that all bituminous coals in the Alabama fields are of like grade if commercially suitable for use in the manufacture of coke generally, regardless of the taxpayer's particular needs. To go further and classify coking coals according to their myriad of actual uses would lead to an unworkable system of grading coal, since the requirements of coke users vary greatly. There would never be, in the case of coking coal, a 'mineral product of like kind and grade'; we would have a phrase without meaning."

Corp. v. *Commissioner*, 26 T. C. 553 (Acq. 1957-1 Cum. Bull. 5); *Wagner Quarries Co.* v. *United States*, 154 F. Supp. 655 (N. D. Ohio), affirmed C. A. 6th, November 14, 1958 (2 AFTR 2d 6104). See also Rev. Rul. 57-584, 1957-2 Cum. Bull. 898. The Court of Appeals correctly held that (Pet. App. 15), as applied to coal, like "kind" refers to a class, in this case bituminous coal mined in the Birmingham area; and like "grade" refers to a subclassification of such kind of coal, here coal of coking qualities. That this is the only meaningful interpretation is buttressed by the fact that coke manufacturers customarily blend together coking coals of various physical qualities in order to produce a desired type of coke. (Pet. App. 9.) To subdivide coking coals into various so-called "grades" based either on individual physical properties or end use would result in hopeless confusion.

3. The taxpayer's assertion that the Court of Appeals erroneously relied upon its decision in *Fleming* v. *Commissioner*, 241 F. 2d 78, reversed *sub nom. Commissioner* v. *P. G. Lake, Inc.*, 356 U. S. 260, is without foundation. The citation of the *Fleming* case by the Court of Appeals (Pet. App. 11) was not for the legal principle which this Court disapproved (*i. e.*, that the transfer of oil payments for real estate is a tax free exchange under Section 112 (b) (1) of the 1939 Code), but was merely to show that the term "kind" as used in the Regulations was a term customarily given a broad rather than a restricted meaning. See also *Fleming* v. *Campbell*, 205 F. 2d 549 (C. A. 5th), and *Commissioner* v. *Crichton*, 122 F. 2d 181 (C. A. 5th), cited for the same proposition.

The asserted conflict (Pet. 4, 10) with other decisions (*Dragon Cement Co.* v. *United States*, 244 F. 2d 513 (C. A. 1st), certiorari denied, 355 U. S. 833; *Townsend* v. *Hitchcock Corp.*, 232 F. 2d 444 (C. A. 4th); *United States* v. *Sapulpa Brick and Tile Corp.*, 239 F. 2d 694 (C. A. 10th)) and the alleged inconsistency between the opinion of the court below and the same court's opinion in other cases (*United States* v. *Cherokee Brick & Tile Co.*, 218 F. 2d 424, and *United States* v. *Merry Brothers Brick and Tile Co.*, 242 F. 2d 708, certiorari denied, 355 U. S. 824) are likewise without foundation. Unlike the present case, those cases did not involve an application of the Treasury Regulations in respect of minerals which were marketable in mineral form; the minerals there involved were *not* marketable in mineral form, and the decisions turned on the proper interpretation of the statutory definition of "mining" as including "the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products" (see Section 114 (b) (4) (B), Appendix, *infra*, p. 15). What the courts held in those cases was that the statutory definition extends to the first "commercially marketable" mineral product and is not limited, as the Government contended, to an unmarketable mineral product.[2] As the court below observed (Pet. App. 13–14, fn. 12), such a holding has no pertinency

[2] As pointed out *supra*, the statute defines "ordinary treatment processes" in the case of "coal" as including "cleaning, breaking, sizing, and loading for shipment". See Section 114 (b) (4) (B). There is no question that the processes employed in converting coal to coke go beyond such ordinary processes.

here, where the commercially marketable product was the crude mineral product having a "representative market or field price." Thus, in *Dragon Cement* it was held that a taxpayer could compute a depletion deduction on the gross income from cement because cement was the first commercially marketable product that could be obtained from the taxpayer's mineral.[3] The other cases involved similar questions with respect to talc (*Townsend*), and brick and tile clay (*Sapulpa; Cherokee Brick & Tile;* and, *Merry Brothers Brick and Tile*).[4] Accordingly, as the Court of Appeals noted, such cases do not apply to the specific question decided here. (Pet. App. 13–14, n. 12.)

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[3] The *Dragon Cement* case is not even mentioned in the opinion below for the reason that it was not even relied upon by taxpayer in the court below. The case was not cited in taxpayer's main brief; and taxpayer's reply brief referred to the case merely with the following observation (p. 5): "While this case may not be in point, we call attention to it inasmuch as the Court's statement of the purpose of the percentage depletion provisions of the Internal Revenue Code is so clear."

[4] The above analysis also serves to distinguish the instant case from others cited by taxpayer. (Pet. 11.) *Iowa Limestone Co.* v. *Commissioner, supra; Dixie Lime Products Co.* v. *United States* (S. D. Fla.), decided September 13, 1957 (52 A. F. T. R. 1336); *Wagner Quarries Co.* v. *United States*, 154 F. Supp. 655 (N. D. Ohio), affirmed C. A. 6th, November 14, 1958 (2 A. F. T. R. 2d 6104), and *Monolith Portland Cement Co.* v. *United States* (S. D. Calif.), decided April 14, 1958 (1 A. F. T. R. 2d 1512). To the extent that the taxpayer relies upon these cases as a proper approach to a definition of like "grade," it should be pointed out that they deal with the statutory concepts of "chemical" and "metallurgical" grade limestone (See Section 114 (b) (4) (A) (iii)), and they necessarily turn on physical and chemical properties of the mineral. They do not involve the question whether there is a representative market for a mineral product of like kind and grade.

CONCLUSION

The decision below is correct. There is no conflict, and no occasion for further review. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *

For percentage depletion allowable under this subsection, see section 114(b), (3) and (4).

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * *

(26 U. S. C. 1952 ed., Sec. 23.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

* * * * *

(26 U. S. C. 1952 ed., Sec. 113.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * * *

(b) *Basis for Depletion.*—

(1) *General rule.*—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection.

(2) [as amended by Sec. 319 (b) of the Revenue Act of 1951, c. 521, 65 Stat. 452] *Discovery value in the case of mines.*—In the case of mines (except mines in respect of which percentage depletion is allowable under paragraph (4) of this subsection), discovered by the taxpayer after February 28, 1913, the basis for depletion shall be the fair market value of the property at the date of discovery or within thirty days thereafter, if such mines were not acquired as the result of purchase of a proven tract or lease, and if the fair market value of the property is materially disproportionate to the cost. The depletion allowance under section 23 (m) based on discovery value provided in this paragraph shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property upon which the discovery was made, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to discovery value. Discoveries shall include minerals in commercial quantities contained within a vein or deposit discovered in an existing mine or mining tract by the taxpayer after February 28, 1913, if the vein or deposit thus discovered was not merely the uninterrupted extension of a continuing commercial vein or deposit already known to exist, and if the discovered minerals

are of sufficient value and quantity that they could be separately mined and marketed at a profit.

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

(4) [as amended by Sec. 145 (a), Revenue Act of 1942, c. 619, 56 Stat. 798, Sec. 124 (a), Revenue Act of 1943, c. 63, 58 Stat. 21, and Sec. 319 (a) of the Revenue Act of 1951, supra] *Percentage depletion for coal and metal mines and for certain other mines and natural mineral deposits.*

(A) *In general.*—The allowance for depletion under section 23 (m) in the case of the following mines and other natural deposits shall be—

* * * * *

(ii) in the case of coal, * * * 10 per centum,

* * * * *

of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

(B) [as added by Sec. 124 (c) of the Revenue Act of 1943, *supra*, amended by Sec. 207 (a) of the Revenue Act of 1950, c. 994, 64 Sfat. 906, and Sec. 304 (d), Excess Profits Tax Act of 1950, c. 1199, 64 Stat. 1137] *Definition of Gross income from Property.*

As used in this paragraph the term "gross income from the property" means the gross income from mining. The term "mining" as used herein shall be considered to include not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products, and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which the ordinary treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills. The term "ordinary treatment processes," as used herein, shall include the following: (i) In the case of coal—cleaning, breaking, sizing, and loading for shipment; (ii) in the case of sulphur—pumping to vats, cooling, breaking, and loading for shipment; (iii) in the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and minerals which are customarily sold in the form of a crude mineral product—sorting, concentrating, and sintering to bring to shipping grade and form, and loading for shipment; (iv) in the case of lead, zinc, copper, gold, silver, or fluorspar ores, potash, and ores which are not customarily sold in the form of the crude mineral product—crushing grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic), cyanidation, leaching, crystallization, precipitation (but not including as an or-

dinary treatment process electrolytic deposition, roasting, thermal or electric smelting, or refining), or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore, including the furnacing of quicksilver ores. The principles of this subparagraph shall also be applicable in determining gross income attributable to mining for the purposes of sections 450 and 453.

(26 U. S. C. 1952 ed., Sec. 114.)

Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939:

SEC. 39.23 (m)–1 [as amended by T. D. 6096, 1954–2 Cum. Bull. 69]. *Depletion of mines, oil and gas wells, other natural deposits and timber; depreciation of improvements.*

* * * * * * *

(e) As used in sections 114 (b) (3) and 114 (b) (4) (A) and §§ 39.23 (m)–1 to 39.23 (m)–19, inclusive, the term "gross income from the property" means the following:

(1) In the case of oil and gas wells, "gross income from the property," as used in section 114 (b) (3), means the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well. If the oil and gas are not sold on the property but are manufactured or converted into a refined product prior to sale, or are transported from the property prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price (as of the date of sale) of the oil and gas before conversion or transportation.

(2) In the case of a crude mineral product other than oil and gas, "gross income from the property," as used in section 114 (b) (4) (A), means the gross income from mining. The term "mining" as used herein includes not only the extraction of ores or minerals from the ground

but also the ordinary treatment processes which are normally applied by the mine owners or operators to the crude mineral product after extraction in order to obtain the commercially marketable mineral product or products. * * *

(3) If the taxpayer sells the crude mineral product of the property in the immediate vicinity of the mine, "gross income from the property" means the amount for which such product was sold, but, if the product is transported or processed (other than by the ordinary treatment processes described below) before sale, "gross income from the property" means the representative market or field price (as of the date of sale) of a mineral product of like kind and grade as beneficiated by the ordinary treatment processes actually applied, before transportation of such product (other than transportation treated, for the taxable year, as mining). If there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes (or, if the product in its crude mineral state is merely transported, the price for which sold) minus the costs and proportionate profits attributable to the transportation (other than transportation treated, for the taxable year, as mining) and the processes beyond the ordinary treatment processes. If the taxpayer establishes to the satisfaction of the Commissioner that another method of computation, other than the computation of profits proportionate to costs, clearly reflects the gross income from the property, then such gross income shall be computed by the use of such other method.

* * * * * * *

(g) "Net income of the taxpayer (computed without allowance for depletion) from the property," as used in section 114 (b) (2), (3) and

(4) and §§ 39.23 (m)-1 to 39.23 (m)-19, inclusive, means the "gross income from the property," as defined in paragraph (e) of this section, less the allowable deductions attributable to the mineral property upon which the depletion is claimed and the allowable deductions attributable to the processes listed in paragraph (f) of this section in so far as they relate to the product of such property, including overhead and operating expenses, development costs properly charged to expense or allowable as deductions under section 23 (ee), depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. Deductions not directly attributable to particular properties or processes shall be fairly allocated. To illustrate: In cases where the taxpayer engages in activities in addition to mineral extraction and to the processes listed in paragraph (f) of this section, deductions for depreciation, taxes, general expenses, and overhead, which cannot be directly attributed to any specific activity, shall be fairly apportioned between (1) the mineral extraction and the processes listed in paragraph (f) of this section and (2) the additional activities, taking into account the ratio which the operating expenses directly attributable to the mineral extraction and the processes listed in paragraph (f) of this section bear to the operating expenses directly attributable to the additional activities. If more than one mineral property is involved, the deductions apportioned to the mineral extraction and the processes listed in paragraph (f) of this section shall, in turn, be fairly apportioned to the several properties, taking into account their relative production.

(h) As used in paragraphs (e) and (f) of this section, the term "crude mineral product" means the product in the form in which it emerges from the mine or well.

* * * * *

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